R5650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 2A

January 12, 1990

KEIRETSU AND OTHER LARGE CORPORATE GROUPS IN JAPAN

Summary

Large corporate groups, where a number of firms typically share a name and loose financial ties, are a characteristic feature of the Japanese economy. U.S. officials currently are tackling the subject of the groups, which have no direct American counterpart, as part of the Structural Impediments Initiative talks with Japanese negotiators.

In taking an interest in such groups, Washington is traveling in the well-worn footsteps of American and Japanese researchers. Such experts have identified several kinds of industrial groups in their efforts to trace the groups' influence on public welfare and to determine the implications for public policy. The financial keiretsu, groups of firms organized around a large commercial bank, are the best known. These experts have found that the impact of keiretsu and similar groups on the Japanese economy has shifted over time and often is different than one might expect.

Concept of Firm Groupings

"Bigger is better" is a common expression in both English and Japanese. Following this maxim firms in both the United States and Japan often try to increase their effectiveness through affiliations of various kinds with other firms. In other instances firms in both countries split for legal or business reasons but maintain significant ties.

In some cases competing companies merge or form cartels to lower their costs by enabling larger sales volumes or to obtain higher prices due to their

increased market power. American economists typically advocate strict limitations on such horizontal combinations in the belief they often harm public welfare.

Horizontal combinations traditionally have been the main concern of policymakers, but today Washington is pressing Tokyo harder on two other kinds of corporate groupings. The first involves linkages between firms that sell to each other. For example, a manufacturer may combine or develop a long-term relationship with a supplier or with a company it supplies, a downstream linkage. Economists generally see more public benefits and fewer public costs to such vertical combinations than they do to horizontal groupings. Washington also is concerned about combinations of firms that are neither competitors nor suppliers of each other. Economists are divided about the adverse -- or positive -- effects of such combinations.

Antitrust policy in both the United States and Japan is most restrictive with respect to horizontal combinations, less so toward vertical linkages and most tolerant of conglomerates. (For details of Japanese policy toward horizontal linkages, see JEI Report No. 20A, May 19, 1989.) However, both the United States and Japan impose some limits, even on conglomerates. For example, in the United States banks may not own manufacturing firms, while in Japan banks generally may own no more than 5 percent of the stock of another business.

Groups of Firms in the United States and Japan

The United States has nearly all of the combinations described above. For example, the leveraged buyouts and the mergers that made headlines in 1989 often involved firms that had diversified into unrelated businesses during the 1960s and 1970s, sometimes with disastrous results. Thousands of U.S. firms have strong vertical links with one another, existing primarily either to sell to a single company (for example, frozen hamburger to McDonald's Corp.) or to sell the product of a single company (McDonald's franchisees.) In addition, some researchers have identified groups of nonfinancial firms under effective control of large banks or other financial services companies.[1] Finally, American entrepreneurs ranging from John D. Rockefeller in the 19th century to Donald Trump toward the end of the 20th have assembled multibillion-dollar corporate empires.

Some American observers of Japan think the process there has gone much further. The name "Mitsubishi" and the Mitsubishi triple diamond logo, for example, are connected with enough services, products and firms to possibly embarrass even Donald Trump. They include the well-known Mitsubishi Corp. (Japan's top trading company), Mitsubishi Motors Corp., Mitsubishi Electric Corp. and Mitsubishi Bank, Ltd. The more obscure Mitsubishi Estate Co., Ltd. (which is in the process of buying a majority interest in Rockefeller Center),

[1]See, for example, David M. Kotz, Bank Control of Large Corporations in the United States (Berkeley: University of California Press, 1978) and the references cited therein.

The JEI REPORT (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

Mitsubishi Pencil Co., Ltd. and Mitsubishi Warehouse & Transportation Co., Ltd. help round out the list of the 22 companies that are traded on the first section of the Japanese stock exchanges under the name "Mitsubishi." That so many firms bear this tag has little to do with the popularity of the name, per se, and even less with the vanity of any mythical Mr. Mitsubishi. However, although not as closely linked as Mr. Trump's enterprises, the firms are related to each other. In addition, dozens of other firms not bearing the same name or using the same trademark are linked to Mitsubishi companies.

The Mitsubishi corporate relationships described above are an example of one of three kinds of corporate groupings in Japan. The best known of these are financial keiretsu (kinyu keiretsu) -- groups of firms organized around a large bank. While member firms may buy and sell to each other, the glue that holds the group together usually is assumed to be mutual stockholding and bank loans to members, supplemented by personnel exchanges and meetings of the leaders. In short, these firms are linked primarily by finances rather than products; the group as a whole has a conglomerate rather than a horizontal or a vertical structure. (However, as shown below, member companies remain separate firms, making the links much weaker than those American groups described as conglomerates, which are organized as a single company.)

Three of the six keiretsu (Mitsui, Mitsubishi and Sumitomo) are direct descendants of the famous World War II era zaibatsu (financial cliques), while the remaining three (Fuyo, Sanwa and Dai-Ichi Kangyo) have less direct links to earlier organizations. The connections in all six, however, are definitely both historical and financial. All six organizations today have matrix-like rather than pyramidal stockholding structures in contrast to the zaibatsu, which were under the control of a holding company. Stockholding -- and influence -- move in both directions between pairs of firms, although loans and personnel are likely to be mainly from the commercial banks and the insurance companies within the group toward the others.

Enterprise Groups and Vertical Distribution Groups

A second major type of interfirm combination is the group organized around an independent firm, often a manufacturer (like Sony Corp.), but sometimes another type of firm, such as a retailer (Daiei, Inc.) or a railroad company (Tokyu Corp.). Japan has dozens of such large independent groups, called enterprise groups. (Some analysts, particularly in the United States, use terms such as industrial keiretsu to describe such groups.) Stockholding in these groups is more pyramidal, strengthening control in the core firm, than in financial keiretsu. In addition, the maximum amount of stock a core firm can own in another nonfinancial company generally is much higher than the 5 percent legal limit for banks -- or even the 10 percent ceiling for insurance companies. The goods and services produced by the group often are complementary, but they need not be.

In each case the core company has the best-known name, which it may or may not lend to other members of the group. It owns the largest shareholdings in other group companies. It also is the most likely source of personnel or technical assistance to other group members, particularly those just beneath it in the group pyramid.

Otherwise, enterprise groups differ considerably. In some groups, such as the Hitachi Group, member firms have moved into a broad range of businesses,

such as construction, consumer electronics and financial services. Other groups consist of related companies that produce the same kind of products as the core firm. For example, Victor Co. of Japan, Ltd., the developer of the VHS format for videocassette recorders and today mainly a manufacturer of that product and audio equipment, is 50.8 percent owned by Matsushita Electric Industrial Co., Ltd., which is best known to American consumers for its Panasonic and Quasar lines of consumer electronics products. Were JVC an American company, it would rank well in the upper echelon of the Fortune 500. It is one of 11 large, publicly traded companies generally considered part of the Matsushita Group.

The third important type of enterprise group consists of a core company that has organized its subcontractors -- and their subcontractors -- into a group, with corresponding stock and personnel ties. Toyota Motor Corp. and its hundreds of affiliated companies typify this pattern.

As noted above, the flow of financial and other resources is mostly one-way in all these enterprise groups. The list of the 20 largest stockholders in Matsushita Electric Industrial does not include JVC or much other representation from the Matsushita Group. (One firm, Matsushita Electric Works Co., Ltd., ranks 19th, holding 1.1 percent of the stock.) However, until his death last year, Konosuke Matsushita, the group's founder, ranked eighth, holding 2.1 percent of the shares. This illustrates another characteristic of such groups and one that distinguishes them from financial keiretsu: one family or individual may hold substantial power.

While not centered around a bank, some large enterprise groups have significant holdings in financial services firms. For example, Toyota is the largest individual stockholder, at 40.6 percent, in Chiyoda Fire & Marine Insurance Co., Ltd., Japan's 10th largest nonlife insurance firm. In addition to being the largest lender to Nissan Fire & Marine Insurance Co., Ltd., Japan's 12th largest nonlife firm, Nissan Motor Co., Ltd. has a 7.3 percent stake, making it the second-largest shareholder. By contrast, the leading nonlife firms, Tokio Marine & Fire Insurance Co., Ltd. and Yasuda Fire & Marine Insurance Co., Ltd., are leading members of the Mitsubishi and the Fuyo financial keiretsu, respectively.

The nonlife insurance companies listed above suggest that financial keiretsu and groups organized around independent firms are alternative group structures. Historically, that was the case. New firms outside the old zaibatsu formed their own groups, sometimes known as new zaibatsu, before World War II. Nissan is a leading example. The practice has continued during the postwar years. Such firms are likely to be much younger than companies associated with zaibatsu or their descendants, explaining why company founders still play leading roles in some relatively independent companies, such as Sony.

Today, however, the situation is not that simple. Some of the core firms of the leading independent groups are themselves members of financial keiretsu, at least in name. While few observers believe that Toyota is in need of a lead bank, the firm nevertheless is a member of the Mitsui keiretsu. Nissan belongs to the Fuyo Group. The companies to which they are linked may or may not belong to the same financial keiretsu. For example, despite Toyota's position as the largest stockholder in Chiyoda Fire & Marine Insurance, the insurer belongs to the inner circle of the Fuyo Group. Nissan Fire & Marine Insurance is part of the Dai-Ichi Group, not in the Fuyo Group with Nissan.

Further frustrating efforts at categorization are those companies that, while strongly associated with financial keiretsu, have their own enterprise groups. For example, Mitsubishi Heavy Industries, Ltd., which plays a major role in the Mitsubishi financial keiretsu, has dozens of firms under it.

In short, financial keiretsu and enterprise groups may be related in several ways. In some situations the leading members of financial keiretsu themselves are at the core of other, distinct large groups of firms, a sort of circle within a circle. In others industrial firms are more independent, with some group members linked to a financial keiretsu (intersecting circles) or two or more financial keiretsu (one circle intersecting with two other circles) or with no strong ties at all. Even where the circles intersect, members of enterprise groups often have a high degree of independence from other members of the financial keiretsu.

Finally, some observers have suggested a third major type of corporate group, the vertical distribution group. In some instances manufacturing firms set up distribution systems, including retail outlets, for their products. Such downstream integration could be considered an extension of any of the three types of enterprise groups discussed above, but the upstream firm is likely to exercise control through such means as exclusive sales arrangements in addition to, or in place of, stock ownership. The core company is likely to be upstream from other members of the group, instead of downstream as is often the case with enterprise groups. Moreover, vertical distribution groups raise different policy issues, as will be seen later.

The three types of corporate groups -- financial keiretsu, enterprise groups and vertical distribution groups -- obviously share some characteristics. Buying patterns among the firms are likely to be closer than they are with nonmembers. However, the practices differ considerably among the three types. Japan's Fair Trade Commission estimated in 1983 that sales to another firm within the same financial keiretsu accounted for 20 percent of sales and 12 percent of purchases.[2] While comparable figures for the other two kinds of keiretsu are not available in the aggregate, data for some specific firms are illustrative.

One of Toyota's affiliated companies, Koito Manufacturing Co., Ltd., a leading maker of automotive lighting equipment and the object of an unwelcome -- and widely publicized -- initiative involving American financier T. Boone Pickens, sells 46 percent of its output to Toyota. (For more on Pickens and Koito, see JEI Report No. 37B, September 29, 1989.) Aisin Seiki Co., Ltd., a maker of transmissions, clutches, brakes and other automotive products and another member of the Toyota Group but more than three times Koito's size, sells 70 percent of its output to Toyota. Were it an American company, Aisin would be in the middle ranks of the 500 largest companies listed by sales, about the size of Apple Computer Inc.

For a retail shop locked into a distribution arrangement with a manufacturer, close to 100 percent of the retailer's purchases often come from the manufacturer. However, the manufacturing firm may opt to have retail outlets

[2]Cited in Thomas Roehl, "Japanese Industrial Groupings: A Strategic Response to Rapid Industrial Growth" (unpublished paper, Graduate School of Business Administration, University of Washington, August 1988), p. 6.

in its distribution system stock other makers' products, including imports. At the same time, though, manufacturer-controlled retail outlets generate a minority of retail sales in Japan, even in sectors where they are most prominent like consumer electronics.

A Fair Trade Commission research group consisting of individuals outside government and headed by Professor Toshimasa Tsuruta of Senshu University recently looked at the question of supplier relationships somewhat differently. The FTC panel sent questionnaires to the 200 largest Japanese nonfinancial firms asking them about their supplier relationships. On the question of financial keiretsu versus enterprise groups, the panel found that among those supplied with producer goods, 5.8 percent of the responding firms mentioned membership in the same vertical group while only 2.3 percent cited membership in a horizontal group. (The FTC defined horizontal groups and vertical groups differently than most other researchers. A relationship was defined as vertical or horizontal based strictly on the type of transaction, regardless of whether the core firm was a financial institution. However, in most cases horizontal relations correspond to financial keiretsu and vertical relations to enterprise groups.) The FTC found similar results (3.3 percent mentioning vertical groups, 2.2 percent horizontal groups) for buyers of capital goods.[3]

In looking at specific products or services, the FTC found divergent patterns, however. For some goods and services affiliation mattered little. For example, with mainframe computers only 10 percent claimed to choose on the basis of group membership or being a major customer of the manufacturer. For others, however, the FTC group found a preference for firms with which the customer had an ongoing formal relationship. High on the list of those mentioning group or financial ties were purchasers of pension fund management services (95.9 percent) and buyers of fire and marine insurance (75.3 percent). The FTC group speculated that the lack of competition in price and quality in the latter two industries led firms to decide on the basis of other criteria. However, the FTC also noted that, in all the business lines it studied, most companies dealt with more than one supplier.

More broadly, the FTC group concluded that group membership was not decisive. As noted, in many cases transactions were concluded without any financial ties between buyer and seller. In those where the thread of such a connection appeared, it often came after the establishment of a long-term supply relationship. In general, the panel found that long-term relationships were pervasive, but past dealings were the main reason they continued.[4]

Characteristics of Financial Keiretsu

The FTC study and other research on keiretsu suggest that all three kinds of corporate groups have the potential for economically important linkages, but that the mere existence of such groupings does not necessarily mean those linkages are very important. If anything, vertical distribution groups

[3]Fair Trade Commission, Long-Term Relationships Among Japanese Companies: Report by the Study Group on Trade Frictions and Market Structure (April 1987), p. 19.

[4]Ibid., pp. 6-7.

and enterprise groups may embody more exclusive arrangements than do financial keiretsu. However, most American and Japanese research has focused on financial keiretsu, partly for historical reasons and partly because the story is more dramatic, involving larger firms and conceivably economy-wide control.

Table 1 shows the members of the "Presidents' Clubs" for each of the six financial keiretsu. These are the groups whose presidents meet, in some cases as often as once a week, to discuss various concerns. In three of the groups membership mirrors fairly closely that of the prewar zaibatsu, although some turnover occurs and members occasionally have been added during the postwar period. Not all the firms listed participate that actively; Toyota, for example, is described as an "observer" in the Mitsui Presidents' Club. In addition, many firms that have obvious connections with a group are not included. Mazda Motor Corp. is conspicuous by its absence from the Sumitomo list even though, by most measures, it has an extremely close relationship with that group. Mazda was on the receiving end of a well-publicized rescue mission in 1979 and 1980 that involved the coordinated efforts of several Sumitomo companies.[5] Many of the best-known Japanese names, such as Matsushita Electric Industrial, Sony and Honda Motor Co., Ltd., also are missing, but most analysts regard these firms as truly independent. (Each is the core of an enterprise group.)

After April 1 Table 1 will take on a slightly different look. Mitsui Bank, Ltd. will merge with Taiyo Kobe Bank, Ltd., an institution of approximately equal size (see JEI Report No. 35B, September 15, 1989). At a minimum the lead bank in the Mitsui Group, to be renamed Mitsui Taiyo Bank, Ltd., will be larger. Conceivably, the combination of Mitsui and Taiyo Kobe could propel some firms that are particularly important to both to membership in the Mitsui Presidents' Club. In other instances, while membership in the Presidents' Club probably will be unaffected, the new bank may replace other keiretsu banks as the most important lender and stockholder. For example, Nomura Securities Co., Ltd. was once a member of the Sanwa Group and a group member, Toyo Trust & Banking Co., Ltd., is still its largest stockholder. After the Mitsui-Taiyo Kobe merger, the new bank will become both the largest stockholder in and the major lender to Nomura, replacing Sanwa Bank, Ltd., another Sanwa Group member, in the latter position.

Table 2 gives an overview of how the role of the six financial keiretsu centered around Mitsui Bank, Mitsubishi Bank, Sumitomo Bank, Ltd., Fuji Bank, Ltd. (the Fuyo Group), Sanwa Bank, and Dai-Ichi Kangyo Bank, Ltd. in the Japanese economy has changed in recent years. At least since the mid-1970s the percentage of total employment accounted for by firms affiliated with the six groups has shown a steady decline. In part this reflects the heavy concentration of the groups on manufacturing, which has shown a slow but fairly consistent decline over the period in question in percentage terms as an employer, if not in output. (For details, see JEI Report No. 23A, June 17, 1988.)

The second row shows that the six financial keiretsu also have lost a modest amount of ground in their role as lenders, suggesting some loss of market share to banks and other financial services firms not affiliated with them. Since lending is widely believed to be critical in cementing relationships,

[5]For details see Richard Pascale and Thomas Rohlen, "The Mazda Turnaround," Journal of Japanese Studies (Summer 1983), pp. 219-63.

Table 1: Presidents' Club Memberships, October 1, 1989

Industry	Mitsui (24 companies)	Mitsubishi (29 companies)	Sumitomo (20 companies)	Fuyo (29 companies)	Sanwa (44 companies)	Dai-Ichi (47 companies)
Commercial Banking	Mitsui Bank	Mitsubishi Bank	Sumitomo Bank	Fuji Bank	Sanwa Bank	Dai-Ichi Kangyo Bank
Trust Banking	Mitsui Trust & Banking	Mitsubishi Trust & Banking	Sumitomo Trust & Banking	Yasuda Trust & Banking	Toyo Trust & Banking	
Life Insurance	Mitsui Mutual Life Insurance*	Meiji Mutual Life Insurance*	Sumitomo Life Insurance*	Yasuda Mutual Life Insurance*	Nippon Life Insurance*	Asahi Mutual Life Insurance* Fukoku Mutual Life Insurance*
Nonlife Insurance	Taisho Marine & Fire Insurance	Tokio Marine & Fire Insurance	Sumitomo Marine & Fire Insurance	Yasuda Fire & Marine Insurance		Nissan Fire & Marine Insurance Taisei Fire & Marine Insurance
Trading	Mitsui	Mitsubishi	Sumitomo	Marubeni	Nissho Iwai** Nichimen Iwatani International	C. Itoh Nissho Iwai** Kanematsu-Gosho Kawasho
Forestry			Sumitomo Forestry			
Coal Mining	Mitsui Mining Hokkaido Colliery*		Sumitomo Coal Mining			
Construction	Mitsui Construction Sanki Engineering	Mitsubishi Construction*	Sumitomo Construction	Taisei	Ohbayashi Zenitaka Toyo Construction Sekisui House	Shimizu
Food and Beverages	Nippon Flour Mills	Kirin Brewery		Nisshin Flour Milling Sapporo Breweries Nichirei	Itoham Foods Suntory*	
Textiles	Toray Industries	Mitsubishi Rayon		Nisshinbo Industries Toho Rayon	Unitika Teijin	Asahi Chemical Industry
Pulp and Paper	Oji Paper	Mitsubishi Paper Mills		Sanyo-Kokusaku Pulp		Honshu Paper
Chemicals	Mitsui Toatsu Chemicals Mitsui Petrochemical Industries	Mitsubishi Kasei Mitsubishi Gas Chemical Mitsubishi Petrochemical Mitsubishi Plastics Industries Mitsubishi Monsanto Chemical*	Sumitomo Chemical Sumitomo Bakelite	Showa Denko Kureha Chemical Industry Nippon Oil & Fats	Tokuyama Soda Sekisui Chemical Ube Industries Hitachi Chemical Tanabe Seiyaku Fujisawa Pharmaceutical Kansai Paint	Denki Kagaku Kogyo Kyowa Hakko Kogyo Nippon Zeon Asahi Denka Kogyo Sankyo Shiseido Lion
Petroleum		Mitsubishi Oil		Tonen	Cosmo Oil	Showa Shell Sekiyu
Rubber					Toyo Tire & Rubber	Yokohama Rubber

Industry	Mitsui	Mitsubishi	Sumitomo	Fuyo	Sanwa	Dai-Ichi
Glass and Cement	Onoda Cement	Asahi Glass Mitsubishi Mining & Cement	Nippon Sheet Glass Sumitomo Cement	Nihon Cement	Osaka Cement	Chichibu Cement
Steel	Japan Steel Works	Mitsubishi Steel Manufacturing	Sumitomo Metal Industries	NKK	Kobe Steel** Nisshin Steel Nakayama Steel Works Hitachi Metals	Kawasaki Steel Kobe Steel** Japan Metals and Chemicals
Nonferrous Metals	Mitsui Mining & Smelting	Mitsubishi Metal Mitsubishi Cable Industries Mitsubishi Aluminum*	Sumitomo Metal Mining Sumitomo Light Metal Industries Sumitomo Electric Industries		Hitachi Cable	Nippon Light Metal Furukawa Furukawa Electric
Nonelectric Machinery		Mitsubishi Kakoki Kaisha	Sumitomo Heavy Industries	Kubota Nippon Seiko	NTN	Niigata Engineering Iseki Ebara
Electric Machinery	Toshiba	Mitsubishi Electric	NEC	Hitachi** Oki Electric Industry Yokogawa Electric	Hitachi** Iwatsu Electric Sharp Kyocera Nitto Denko	Hitachi** Fuji Electric Yaskawa Electric Manufacturing Fujitsu Nippon Columbia
Transportation Equipment	Mitsui Engineering & Shipbuilding Toyota Motor	Mitsubishi Heavy Industries Mitsubishi Motors		Nissan Motor	Hitachi Zosen Shin Meiwa Industry Daihatsu Motor	Kawasaki Heavy Industries Ishikawajima-Harima Heavy Industries Isuzu Motors
Precision Instruments		Nikon		Canon	Hoya	Asahi Optical
Department Stores	Mitsukoshi				Takashimaya	Seibu Department Store*
Finance					Orix	Nippon Kangyo Kakumaru Securities Orient
Real Estate	Mitsui Real Estate Development	Mitsubishi Estate	Sumitomo Realty & Development	Tokyo Tatemono		
Transportation/ Communications	Mitsui O.S.K. Lines Mitsui Warehouse	Nippon Yusen Mitsubishi Warehouse & Transportation	Sumitomo Warehouse	Tobu Railway Keihin Electric Express Railway Showa Line	Hankyu Nippon Express** Navix Line	Nippon Express** Kawasaki Kisen Kaisha Shibusawa Warehouse
Services						Korakuen

*Unlisted company.
**Member of two or more Presidents' Clubs.

Source: Toyo Keizai, Kigyo Keiretsu Soran (1990), p. 58.

Table 2: Importance of Financial Keiretsu in the Japanese Economy

	FY 1974	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Employment*	n.a	n.a.	4.6%	4.5%	4.4%	4.1%	4.0%
Financing**	40.1	38.9	38.1	38.9	37.4	37.7	35.4
Large Corporation Dependence on Borrowed Funds***	46.7	2.6	1.7	4.8	-15.7	5.8	11.1

*As a percentage of employment in all firms.
**As a percentage of lending to firms listed on Japanese stock exchanges. The figure for FY 1974 is for April 30, 1975. Other figures are at end of fiscal year.
***Net short- and long-term borrowing by firms capitalized at more than Y1 billion as a percentage of total internal and external funds.

Sources: First two rows: Toyo Keizai, Kigyo Keiretsu Soran (1975-76 and 1990 editions).
Third row: Bank of Japan, "Financial Statements of Principal Enterprises" in Economic Statistics Monthly, various issues.

this would suggest that over the past 15 years their combined influence has waned only slightly. However, the third row demonstrates that, in fact, the changes between the large banks and their big customers has been dramatic. During the early 1970s big Japanese firms depended on banks and other financial institutions for almost half their funds, but in the late 1970s a change of historical proportions began: firms increasingly were able to finance their activities using retained earnings and depreciation charges.

Beginning in the early 1980s capital market liberalization led firms still further away from banks for their financing needs as the companies moved more and more directly to capital markets, selling bonds and other securities in Japan and abroad. In fact, the table shows that in 1986 these large firms actually were net lenders to the financial system. Only with a capital spending boom of unprecedented proportions in 1988 and 1989 did large firms' demand for funds become substantial enough to again make them significant borrowers in the fiscal year ending March 31, 1989. (This analysis concentrates on large firms because the critical linkage is between them and large banks. Data for all firms show that the falling dependence on bank borrowing has been true for companies of all sizes, although the shift is less dramatic for smaller companies.)

In short, the conclusion to be drawn from Table 2 is that keiretsu firms played a smaller role in the Japanese economy during the 1980s. The data from Table 3, which show stock shareholding, suggest that the results have been similar for each major player. Over the period from FY 1974 to FY 1988 keirestu firms came to hold a smaller percentage of corporate stock than previously, although in most cases holdings have increased modestly during the past four years or so.

Table 3: Importance of Financial Keiretsu Shareholding

(percent of total shares in Japan)

Group	FY 1974	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Mitsui	3.07%	2.09%	2.05%	2.08%	2.15%	2.16%
Mitsubishi	3.63	2.49	2.52	2.62	2.74	2.88
Sumitomo	2.02	1.73	1.73	1.68	1.72	1.63
Fuyo (Fuji Bank)	4.27	2.70	2.63	2.62	2.74	3.16
Sanwa	4.28	3.06	2.96	2.95	3.17	3.21
Dai-Ichi	5.59	3.91	3.77	3.75	3.93	4.00
Total	22.86	14.52	14.29	14.36	15.00	15.54
Number of firms	166	162	164	164	164	164

Note: Data for FY 1984-FY 1988 count firms that are members of two or more Presidents' Clubs in both groups. As a result, the sum of the group figures exceeds the total figure for those years.

Source: Toyo Keizai, Kigyo Keiretsu Soran (1975-76 and 1990 editions).

None of these statistics fully describes the perceived differential leadership qualities and goal orientation found in the groups. Despite their size, financial keiretsu may be like the brontosaurus (or apatosaurus), a giant dinosaur with a tiny brain insufficient to ensure the beast's long-run survival on the planet. Some analysts would dismiss the Fuyo, Sanwa and Dai-Ichi keiretsu at the outset, feeling they are ineffective. As evidence, they point to the fact that not only do some firms belong to two or more of these groups, with Hitachi, Ltd. belonging to all three, but the groups often include competing firms, especially two or more trading companies, in marked contrast to the Mitsui, Mitsubishi and Sumitomo groups. To these analysts, these characteristics suggest a lack of cohesiveness in the three.[6]

Of the three former zaibatsu groups, many analysts give high marks to Mitsubishi for being the most goal-directed and having strong leadership. Mitsubishi, for example, is said to impose strict standards, particularly in comparison with Mitsui, in screening potential firms for the use of its name.

The question of keiretsu cohesiveness, in addition to the group philosophy and structure, involves three features: exchanges of stock among members, officers and directors dispatched to other firms and lending. As noted above, Table 2 suggests that lending has become far less important. Table 4, which shows mutual levels of stockholding, reveals that there has been little change in recent years. Further analysis of the figures from which Table 4 are derived suggests that shareholding between pairs of firms within a keiretsu is often smaller than shareholding by individual corporate nonmembers.

[6]See, for example, Kenichi Imai, "Kigyo Gurupu," in Kenichi Imai and Ryutaro Komiya (eds.), Nihon no Kigyo (Tokyo: University of Tokyo Press, 1989), pp. 144-46.

Table 4: Average Level of Mutual Shareholding Among Keiretu Members

Group	CY 1963	CY 1975	CY 1979	FY 1985	FY 1988
Mitsui	9.9%	17.5%	17.9%	17.9%	17.1%
Mitsubishi	14.3	27.8	26.9	25.2	26.9
Sumitomo	13.0	25.9	27.2	25.0	24.4
Fuyo	7.0	13.8	15.8	15.8	15.3
Sanwa	10.2	14.1	16.9	16.8	16.4
Dai-Ichi	8.3	14.2	14.4	13.3	12.2

Notes: The average level of mutual stockholding refers to the average percentage of a member firm's stock held by all other group members.

Membership in the groups expanded significantly between 1963 and 1975, with ambiguous consequences for levels of mutual shareholding. In addition, the 1963 figures exclude holdings by trust banks.

Sources: For 1963, Richard Caves and Masu Uekusa, Industrial Organization in Japan, p. 64.; for 1975-1988, Toyo Keizai, Kigyo Keiretsu Soran (1980 and 1990 editions).

On the question of sending officers and directors to other firms the data are less complete, and the large banks show divergent trends. Between 1981 and 1989 Mitsui and Dai-Ichi Kangyo banks sent a roughly constant number of high-ranking employees to other firms, while Mitsubishi, Fuji and Sumitomo banks gradually increased their numbers by a cumulative 10 to 20 percent. Sanwa Bank steadily raised its number, resulting in a cumulative increase of 50 percent over the eight years. Of course, with the economy growing, some increase could be expected. However, the increases for Mitsubishi, Sumitomo and Sanwa suggest a rise greater than expected from economic growth alone.

American researchers, often using data from the late 1960s and 1970s, generally have concluded that financial keiretsu have been unable to act in a unified fashion because stockholding, lending, exchanges of officers and directors and traditions together have been too weak to compel such behavior. For example, Richard Caves and Masu Uekusa in 1976 found themselves in agreement with Eleanor Hadley's 1970 conclusion that decisions could at most be influenced, not compelled, adding, "The bank groups show little cohesion except among subgroups of firms, and the cross-ties of ownership are relatively weak."[7] While the data on officers and directors hint at the possibility of having to modify that conclusion slightly, many of the other changes in recent years point in the opposite direction.

Effects of Keiretsu

Keiretsu are far from an overwhelming force in the Japanese economy, but they still may have important effects on the way firms in Japan operate, particularly member firms. Both American and Japanese researchers have addressed this question.

[7]Richard E. Caves and Masu Uekusa, Industrial Organization in Japan (Washington, D.C.: Brookings Institution, 1976), p. 67.

Financing - Obviously the large bank at the core of a financial keiretsu is a subject of interest. Through its lending it conceivably could give members of the group a "break." At the other extreme it might try to exploit its privileged position as a stockholder. Professors Caves and Uekusa, on the basis of data from the 1960s, argue the latter.[8] This vintage 1976 conclusion fits neatly with a very recent study that found firms abandoning their main banks for securities markets, even though this alternative made them more dependent on their own earnings in fund-raising -- in technical jargon, more "liquidity constrained."[9] Putting these researchers' arguments together, a keiretsu's non-financial members may have traded some of the ability to borrow in good times and bad that comes from their close keiretsu ties for the better deals they can get on funds raised in other ways, especially in securities markets.

Keiretsu as insurance - This argument suggests that keiretsu firms form kind of a mutual insurance group. In this case, if a given firm gets into trouble, it can count on keiretsu members to help bail it out, as the Sumitomo Group clearly did with Mazda. The "insurance premiums" keiretsu firms pay for this benefit are the foregone opportunities to make higher short-run profits by, for example, shopping around for lower rates from a bank other than its main bank or working out deals with a firm other than the group's trading company.

Just as one swallow does not suggest a spring, one Mazda-type episode does not confirm a keiretsu as an insurance set-up. But, if the hypothesis carries some truth, firms getting "insurance" should have more stable earnings than those that do not. Iwao Nakatani of Osaka University argues that keiretsu in general have worked to have a stabilizing effect on the operating performance of member firms.[10] However, Akiyoshi Horiuchi of the University of Tokyo and two other researchers have argued that their research casts doubt on Professor Nakatani's hypothesis, although they allow that in exceptional circumstances a keiretsu bank may find a Mazda-type rescue in its interest merely to salvage its own reputation as a monitor of lending.[11]

Keiretsu and profits - For most American firms at least, profits are the bottom line. The results from Professors Caves and Uekusa, Nakatani and Roehl for the 1950s and through 1975 are fairly consistent: keiretsu may have been

[8] Ibid., p. 82.

[9] Takeo Hoshi, Anil Kashyap and David Scharfstein, "Bank Monitoring and Investment: Evidence From the Changing Structure of Japanese Corporate Banking Relationships," National Bureau of Economic Research Working Paper No. 3079, August 1989, p. 25.

[10] Iwao Nakatani, "The Economic Role of Corporate Grouping" in Masahiko Aoki (ed.), The Economic Analysis of the Japanese Firm (Amsterdam: Elsevier, 1984).

[11] Akiyoshi Horiuchi, Frank Packer and Shin'ichi Fukuda, "What Role Has the Main Bank Played in Japan," Journal of the Japanese and International Economies, No. 2, 1988, pp. 159-180.

more profitable in the earliest postwar years but were, if anything, less profitable by the 1970s.[12]

What about more recently? A comparison is difficult because keiretsu firms as a group differ in many respects from other companies. Simple profitability comparisons of the members of the Presidents' Clubs with other firms suggest that keiretsu groups generally were less profitable between FY 1984 and FY 1988 than either all manufacturing firms or all Japanese companies. However, this conclusion is complicated by the inclusion of trading companies, which have unusual profitability characteristics, in the keiretsu group figures.

For example, in FY 1988 all firms traded on Japanese stock exchanges had a rate of return on sales of 3.9 percent; manufacturing firms earned 5.8 percent. The six keiretsu, excluding financial firm members, varied in profitability from 1.88 to 3.47 percent. In other words, none of the keiretsu equaled the economy-wide averages. Excluding trading companies from the keiretsu figures lifted average profitability to 5.3 percent, above the average of all firms but below the manufacturing average, a striking result considering that without trading companies and financial firms, keiretsu overwhelmingly are made up of manufacturing companies. The FY 1988 result is not unique: for none of the years from FY 1984 to FY 1988 could keiretsu firms, excluding trading companies, equal the overall average for manufacturing firms.

Such figures can be questioned on various grounds. The rate of return on equity rather than sales would be a more apt comparison, for example, because keiretsu firms may differ from others in their degree of vertical integration. If less integrated, they could be expected to have a lower rate of return on sales than a more integrated firm with the same rate of return on equity. A priori, however, it is not clear whether such problems bias the figures one way or the other. On balance, the recent figures reinforce the impression conveyed by earlier data that keiretsu firms, as a group, still are less profitable than their independent counterparts.

Keiretsu and Other Corporate Groups as a Policy Issue

American and Japanese economists could be forgiven for thinking that all their studies had put the keiretsu issue to rest. Financial keiretsu appear to resemble the lumbering brontosaurus more than the terrifying tyrannosaurus and, like both, seem headed for eventual demise. Certainly American policymakers would appear to have other things to worry about. Yet, Washington has made keiretsu one of the centerpieces of the Structural Impediments Initiative discussions. While press reports suggest that the main concern is financial keiretsu, American negotiators apparently have the enterprise groups in mind as well.

One problem for Washington is the alleged tendency of Japanese firms to stick with an established supplier and to avoid shopping around for the best price. As noted above, such practices are more common for transactions within enterprise groups than among members of financial keiretsu. Wherever they occur, however, these exclusionary business practices tend to keep both new foreign and Japanese firms from becoming suppliers. Tokyo responds that long-term

[12]Cited by Masahiko Aoki, Information, Incentives, and Bargaining in the Japanese Economy (Cambridge: Cambridge University Press, 1988), p. 206.

relationships have many economic benefits, including closer ties that permit the more efficient development of new products, lower inventories and fewer production disruptions.

Washington also may be interested in how financial keiretsu affect the cost of capital. Many U.S. analysts argue that Japanese firms benefit from an unfair advantage in what they have to pay for loans, being able to borrow at lower rates than U.S. firms. Whatever the merits of this argument -- and the merits are debatable -- it certainly does not apply to financial keiretsu. As noted above, if anything, the effect of keiretsu has been to raise the cost of capital for firms in the group.

In addition, Washington is reported to be interested in the effect of financial keiretsu and other corporate groups on the ability of foreign firms to acquire Japanese companies. The interlocking shareholdings in both financial keiretsu and enterprise groups are substantial. Many American experts, and some on the other side of the Pacific, admit cross-stockholding amounts to an effective takeover defense. By themselves, however, the shares of members in a fellow financial keiretsu firm often are too small to prevent a takeover if nonmembers feel otherwise.

As noted in Table 4, mutual shareholding averages between 12 and 27 percent among the six financial keiretsu. This suggests that, in the typical firm, between 88 percent and 73 percent of all shares are held by firms or individuals that are not members of the keiretsu. If these remaining shares are widely dispersed, those held within the keiretsu would be decisive, but the main holders of shares outside the keiretsu often are members of other keiretsu or are other powerful companies. This means, for example, that while a group of Mitsui companies conceivably might band together to try to fight off a takeover of a Mitsui firm, they could be outvoted if some combination of Sumitomo keiretsu stockholders, Industrial Bank of Japan, Ltd. and Nippon Life Insurance Co. feel differently about the takeover of the Mitsui company.

Enterprise groups may be different in this regard. In these cases much larger blocks of stock are in one company's hands. It may be able to thwart a hostile bidder by merely voting its own stock. One has to wonder, however, whether making takeovers of enterprise group companies easier really is in the interest of the Japanese and the American public. While many experts regard takeovers as useful devices to make firms more efficient, others worry about the disruption such actions cause. Some Japanese analysts also are concerned that hostile takeovers, whether or not they involve a foreign company, run counter to the Japanese concept of the firm.

In the case of Japan's enterprise groups, an additional argument that Professors Caves and Uekusa made concerning financial keiretsu may be relevant. They noted that a group of firms that trades with each other often can maximize its total profits by pricing intragroup exchanges at competitive levels and selling to outsiders at whatever the market will bear. As a sweetener for member firms supplying intermediate products to price sales to group members at less than what they could otherwise get, a series of payments might be necessary.[13]

[13]For details of this argument, see Caves and Uekusa, op. cit., p. 61.

Messrs. Caves and Uekusa found the evidence for this argument unconvincing for financial keiretsu, but for at least some enterprise groups, where intragroup sales are much more important, it may be correct. As applied to the Toyota Group, for example, Koito may lower its prices and forgo some profit on its sales to Toyota in order to maximize the profit of the group; however, it obtains some kind of preferential treatment from the rest of the group, now or in the future. The deal is worth it to the rest of the Toyota Group if the motor vehicle manufacturer can sell a larger volume of cars -- albeit at a somewhat lower price -- and earn a higher profit than it could in the absence of such an arrangement.

An American corporate raider poring over Koito's books might see only part of this quid pro quo, the low price of Koito products sold to Toyota. In other words, a successful bid for the company could result in a higher price for Koito's products sold to Toyota at the expense of the hidden transfers to Koito. Such an outcome, if successful, could raise the price not just of Koito's products but of Toyota's as well, in addition to reducing the profits of both Toyota and Koito once the hidden transfers are added to Koito's profits. In such a case, Koito and Toyota shareholders and Japanese and American car buyers would all be losers, although Detroit could come out ahead.

Finally, Washington no doubt sees a connection between keiretsu and another concern on its list, Japanese antitrust enforcement. Discriminatory buying policies of the kind enterprise groups may practice, for example, are subject to Japanese antimonopoly law. In addition, vertical distribution groups consisting of retailers and manufacturers involve exclusive arrangements of a sort that could be of questionable legality under Japanese antitrust law. Washington apparently would like Tokyo to enforce existing Japanese law against such practices. However, in something of a revolution, many American economists no longer are as certain as they were 10 years ago that such practices damage the economy. They see many benefits accruing, for example, from a manufacturing firm being able to exercise some control over how its products are distributed.[14] This new thinking raises the obvious question as to whether or not Washington wants Tokyo to adhere to stronger antitrust activities than many U.S. economists are convinced are appropriate.

Conclusion

As Washington has put more and more aspects of the Japanese economy under the microscope, Japan's corporate groups could hardly escape its notice. In part, this is because they take several forms. While American policymakers seem to believe they have discovered a dangerous virus, they would do well to take a hard look at the work of a generation of American and Japanese economists, often working together, who have found financial keiretsu, at least, to be fairly benign. Other kinds of Japanese corporate groups may present more serious problems, but research on enterprise groups and vertical distribution groups has been far less extensive. Even where exclusive or preferential buying patterns can be shown to exist, many American (as well as Japanese) economists would argue that the practices may be beneficial to economic welfare.

[14]For details of this argument, see Lawrence J. White, "The Revolution in Antitrust Analysis of Vertical Relationships: How Did We Get from There to Here" in Robert J. Larner and James W. Meehan, Jr. (eds.), Economics and Antitrust Policy (New York: Quorum Books, 1989), pp. 103-121.

Even granting that the three kinds of corporate groups do sometimes create problems, observers would be reassured if Washington at least confirmed the existence of a specific problem before advocating a rush to the operating room. And Tokyo surely must be wondering what kind of surgery Washington will recommend to rid the Japanese economy of any ills discovered. At this point the United States seems eager for the Japanese government to take up the surgeon's scalpel but not sure how it would like Tokyo to wield it. For example, after Washington trotted out a survey of buying practices of Japanese firms, questions arose over whether transactions among Japanese companies should be regulated to such a degree that Tokyo might have to order private companies to buy from -- or sell to -- different companies than the firms believe is in their business interest.

While the Japanese economy is healthy enough to withstand even considerable economic malpractice, asking a second opinion would seem appropriate. In this case American and Japanese researchers who already have considerable experience on the question could provide such an opinion once they get a clearer description of the latest troublesome symptoms.

For further information, contact Douglas Ostrom.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.